

Cryptos Are a Threat to Central Banks. Why It Goes Beyond Bitcoin.

By [Daren Fonda](#) Updated May 2, 2021 / Original April 30, 2021



Illustration by Quick Honey



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Most of us go to the Bahamas for the sun and surf. Central bankers may be visiting for another reason: to check out the country's new digital currency, the Sand Dollar. The Bahamas is one of three countries to launch a digital currency, along with China and Cambodia. Sand Dollars are now loaded in mobile wallets on smartphones; to buy a beer, simply scan a QR code—more convenient than swiping a credit card or using a grubby dollar bill.

Digital currencies aren't yet widespread, but [a race is on](#) to get them into circulation as battle lines harden between cryptocurrencies and standbys like the dollar.

More than 85% of central banks are now investigating digital versions of their currencies, conducting experiments, or moving to pilot programs, according to PwC. China is leading the charge among major economies, pumping more than \$300 million worth of a digital renminbi into its economy so far, ahead of a broader rollout expected next year. The European Central Bank, Bank of Japan, and Federal Reserve are

investigating digital currencies. A “Bitcoin” may eventually be issued by the Bank of England. Sweden is lining up an e-krona and might be the first cashless nation by 2023.

Money already flows through electronic circuits around the globe, of course. But central bank digital currencies, or CBDCs, would be a new kind of instrument, similar to the digital tokens now circulating in private networks. People and businesses could transact in CBDCs through apps on a digital wallet. Deposits in CBDCs would be a liability of a central bank and may bear interest, similar to deposits held at a commercial bank. CBDCs may also live on decentralized ledgers, and could be programmed, tracked, and transferred globally more easily than in existing systems.

New [cryptocurrencies and payment systems](#) are raising pressures on central banks to develop their own digital versions. Bitcoin, while popular, isn’t the main threat. It’s highly unstable—more volatile than the Venezuelan bolivar. Many investors sock it away rather than use it, and the underlying blockchain network is relatively slow.

But the [cryptocurrency market](#) overall is gaining critical mass—worth \$2.2 trillion in total now, with half of that in Bitcoin. Central bankers are particularly concerned about “stablecoins,” a kind of nongovernmental digital token pegged at a fixed exchange rate to a currency. Stablecoins are gaining traction for both domestic and cross-border transactions, particularly in developing economies. Technology and financial companies aim to integrate stablecoins into their social-media and e-commerce platforms. “Central banks are looking at stablecoins the way that taxi unions look at Uber—as an interloper and threat,” says Ronit Ghose, global head of banks research at [Citigroup](#).

While many stablecoins are now circulating—the largest is Tether, with \$51 billion in circulation, versus \$2.2 trillion for the dollar—a big one may be arriving soon in Diem, a stablecoin backed by [Facebook](#) (ticker: FB). Diem may launch this year in a pilot program, reaching Facebook’s 1.8 billion daily users; it’s also backed by Uber and other companies. The potentially rapid spread of Diem is raising the ante for central bankers. “What really changed the debate is Facebook,” says Tobias Adrian, financial counsellor at the International Monetary Fund. “Diem would combine a stablecoin and payments platform into a vast user base around the world. That’s potentially very powerful.”

“The private sector is throwing down the gauntlet and challenging the central bank’s role.”

— Ed Yardeni

The broader force behind CBDCs is that money and payment systems are rapidly fracturing. In the coming years, people might hold Bitcoin as a store of value, while transacting in stablecoins pegged to euros or dollars. “The private sector is throwing down the gauntlet and challenging the central bank’s role,” says economist Ed Yardeni of Yardeni Research.

The dollar won’t disappear, of course—it’s held in vast reserves around the world and used to price everything from computers to steel. But every fiat currency now faces more competition from cryptos or stablecoins. And stablecoins in widespread use could upend the markets since they aren’t backstopped by a government’s assets; a hack or collapse of a stablecoin could send shock waves as people and businesses clamor for their money back, sparking a bank run or financial panic. And since they’re issued by banks or other private entities, they pose credit and collateral risks.

As commerce shifts to these digital coins, along with other cryptocurrencies and peer-to-peer networks, governments risk losing control of their monetary policies—tools that central banks use to keep tabs on inflation and financial stability. “Central banks need to create digital currencies to maintain monetary sovereignty,” says Princeton University economist Markus Brunnermeier. The Fed, for instance, manages the money supply by buying or selling securities that expand or contract the monetary base, but “if people aren’t using your money, you have a big problem,” says Rutgers University economist Michael Bordo.

It isn’t all about playing defense, though. Proponents of CBDCs say there are economic and social benefits, such as lower transaction fees for consumers and businesses, more-effective monetary policies, and the potential to reach people who are now “unbanked.” CBDCs could also help reduce money laundering and other illegal activities now financed with cash or cryptos. And since central banks can’t stop the rise of privately issued digital money, CBDCs could at least level the playing field.

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While CBDCs have bounced around academia for years, China’s pilot project, launched last year, was a wake-up call. Analysts say China aims to get its digital renminbi into circulation for cross-border transactions and international commerce; the standard renminbi now accounts for 2.5% of global payments, well below China’s 13% share of global exports, according to [Morgan Stanley](#).

In China, transactions on apps like Alipay and WeChat now exceed the total world volume on Visa (V) and Mastercard (MA) combined. The Chinese apps have also become platforms for savings, loans, and investment products. CBDCs could help regulators keep tabs on money flowing through the apps, and help prevent stablecoins from usurping the government's currency. "That's why the People's Bank of China had to claim its property back—for sovereignty over its monetary system," says Morgan Stanley chief economist Chetan Ahya.

Momentum for digital currencies is also building for "financial inclusion"—reaching people who lack a bank account or pay hefty fees for basic services like check cashing. About seven million U.S. households, or 5% of the total, are unbanked, according to the Federal Deposit Insurance Corp. Democrats in Congress recently proposed legislation for a digital-dollar wallet called a FedAccount, partly to reach the financially disadvantaged.

Governments could also target economic policies more efficiently. Stimulus checks could be deposited into e-wallets with digital dollars. That could bypass checking accounts or apps that charge fees. It could be a way to get money into people's hands faster and see how it's spent in real time. Digital currencies are also programmable. Stimulus checks in CBDC could vanish from a digital wallet in three months, incentivizing people to spend the money, giving the economy a lift.

Researchers at the Bank of England estimate that if a digital dollar went into widespread circulation, it could permanently lift U.S. output by 3% a year. That may be a stretch, but central banks, including the Fed, are now building systems for banks to settle retail transactions almost instantly, 24/7, at negligible cost. CBDCs could slide into that infrastructure, cutting transaction fees and speeding up commerce. That could reduce economic friction and lead to productivity gains for the economy.

Some economists view CBDCs as a monetary-policy conduit, as well. Deposits of \$1 million or more in CBDCs, for instance, might incur a 0.25% fee to a central bank, disincentivizing people and institutions from hoarding savings in a protracted slowdown. "It's costly for the economy if wealthy people shift money into cash or equivalent securities," says Dartmouth College economist Andrew Levin. "This would disincentivize that from happening."

Digital currencies aren't without controversy, though, and would need to overcome a host of technological issues, privacy concerns, and other hurdles. For one, they could

make it easier for governments to spy on private-party transactions. Anonymity would need strong safeguards for a CBDC to reach critical mass in North America or Europe. Chinese officials have said their CBDC will preserve privacy rights, but critics say otherwise. The country's new CBDC could "strengthen its digital authoritarianism," according to the Center for a New American Security, a think tank in Washington, D.C.

There are challenges for commercial banks, too. Central banks could compete with commercial banks for deposits, which would erode banks' interest income on assets and raise their funding costs. Various proposals address those concerns, including compensating banks for services in CBDCs. Deposit rates would have to be competitive so that central banks don't siphon deposits. But even in a two-tier financial model, commercial banks could lose deposits, pushing them into less stable and higher-cost sources of funding in debt or equity markets.

More disconcerting for banks: They could be cut out of data streams and client relationships. Those loops are critical to selling financial services that can generate more revenue than lending. "CBDCs will pose more competition to the banking sector," says Ahya. "It's about the loss of data and fee income from financial services."

Banks in the U.S., Europe, and Japan don't face imminent threats, since regulators are going slow. As incumbents in the system, banks still have vast advantages and could use CBDCs as a means of cross-selling other services. Most of the advanced CBDC projects are for wholesale banking, like clearing and settlement, rather than consumer banking. The ECB, for instance, has said it may limit consumer holdings to 3,000 euros, or about \$3,600, in a rollout that may not kick off until 2025.

A timeline for a digital dollar hasn't been revealed by the Fed and may take congressional action. More insights into the Fed's thinking should be coming this summer: The Boston Fed is expected to release its findings on a prototype system. One compromise, rather than direct issuance, is "synthetic" CBDC—dollar-based stablecoins that are issued by banks or other companies, heavily regulated, and backed by reserves at a central bank.

Whatever they develop, central banks can't afford to be sidelined as digital tokens blend into social-media, gaming, and e-commerce platforms—competing for a share of our wallets and minds. Imagine a future where we live in augmented reality, shopping, playing videogames, and meeting digital avatars of friends. Will we even think in terms of dollars in these walled gardens? That future isn't far off, says the economist Brunnermeier. "Once we have these augmented realities, competition among currencies will be more pronounced," he says. "Central banks have to be part of this game."

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